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How Tax Data Is Processed by the IRS

Data from filed tax returns and information returns is recorded in computers on magnetic tape which is sent to the National Computer Center in Martinsburg, West Virginia, for posting to the master list of taxpayers arranged by account number. Failure to file returns, duplicate or multiple filings, and other discrepancies can be detected. Data from information returns is matched with the entries on individual returns.

You are required to put your Social Security number on your tax return. Your number also appears on information returns sent to the IRS reporting the wages, interest, dividends, royalties, etc., paid to you. Your number serves as a basis for posting and cross-referencing data to your account in the master IRS file.

You may incur penalties and interest charges if you fail to comply with reporting requirements or fail to pay your taxes on time.

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¶47.1 IRS Preliminary Review

Your return is first checked for arithmetic accuracy by the IRS. If an error is found, you receive either a refund or a bill for additional taxes. Special IRS screening also spots the following types of errors:

- Incorrectly reporting income shown on Forms W-2 or Forms 1099.
- Incorrectly applying the adjusted gross income limitations for medical expenses, casualty and theft losses, and miscellaneous itemized deductions.
- Using an auto mileage rate for business travel exceeding the IRS rate.
- Claiming of the dependent care credit by a married person filing separately; *see* ¶25.1.
- Using head of household rates without noting the name of a qualifying child who is not your dependent.
- Not supplying the Social Security number of a dependent.

If you make errors of this type, you will probably be advised by mail of the corrections and of additional tax due, or you may be asked to provide additional information to substantiate tax deductions or credits. If you disagree with an IRS assessment of additional tax, you may request an interview or submit additional information. If you file early for 1996 and the correction is made before April 15, 1997, interest is not charged.

If you fail to provide a dependent's Social Security number, the IRS may make an immediate assessment based on a disallowance of the exemption. You have 60 days to object to an immediate assessment.

If your return is selected for a more thorough review, you are notified by letter. This may not happen for a year or two. How to handle an audit if your return is selected for examination is discussed in Chapter 48.

If you are due a refund on your 1996 return, the IRS follows a practice of expediting refunds to avoid interest costs. Interest is not required to be paid on refunds before May 31, 1997, which is 46 days after April 15, the day the tax was due. If the overpayment is not refunded within 45 days, interest is paid from the date the tax was overpaid up to a date determined by the IRS that can be as much as 30 days before the date of the refund check.

¶47.2 Information Returns Required by the IRS

The IRS matches tax returns with information returns from employers, payers of interest and dividends, brokers, and others to check whether income has been omitted from an individual's tax return. The IRS processes more than one billion information returns, primarily Forms W-2 and Forms 1099. By matching these information returns against individual tax returns, the IRS assesses billions in additional tax and penalties.

Here is a list of items for which an information return will be sent to the IRS:

Wages. Employers report wage income on Form W-2.

Dividends. Dividend payments of \$10 or more during the calendar year are reported to the IRS on Form 1099-DIV. Each payer must furnish you by January 31, 1997, a statement showing the dividend payments made in 1996. Corporations, banks, and other payers, as well as persons or firms who receive such payments for you as nominee, report annually the dividend payments totaling \$10 or more per person. Dividends, for reporting purposes, include dividends paid by corporations, and "dividend equivalents" paid to you while your stock is on loan for a short sale. Nontaxable distributions paid to shareholders are reported to the IRS on Form 5452.

Interest. Interest payments of \$10 or more during the calendar year are reported to the IRS on Form 1099-INT. Each payer must furnish you by January 31, 1997, a statement showing the interest payments made in 1996. Interest for reporting purposes includes interest on registered corporate bonds, debentures, notes, and certificates, as well as interest on deposits with savings banks, savings and loan associations, stockbrokers, and insurance companies. No returns are required for tax-free interest.

Original issue discount (OID). The discount on time deposits and certificates maturing in more than one year is reported to the IRS on Form 1099-OID if it is at least \$10. You should receive a copy of the Form 1099-OID for 1996 by January 31, 1997.

Interest and dividend income information disclosed to Social Security and other agencies. To verify your eligibility for certain government benefits, agencies such as the Social Security Administration, state unemployment compensation agencies, and state welfare agencies may obtain from the IRS information on the interest and dividend income shown on your tax return.

Rents or royalties. Royalty payments of \$10 or more are reported on intangible property, such as copyrights and interests in oil, gas, and other natural resources, on Form 1099-MISC. Rents collected by a real estate agent on behalf of the property owner of \$600 or more also are reported on Form 1099-MISC.

State income tax refunds. States are required to report income tax refunds of \$10 or more on Form 1099-G.

Unemployment compensation. Unemployment payments of \$10 or more during the year are reported to the IRS on Form 1099-G, a copy of which will be furnished to unemployment benefit recipients.

Proceeds from real estate transactions. Real estate sales are reported on Form 1099-S to the IRS by the attorney or other party who is responsible for closing the transaction. On the sale of a home, the form must also show the portion of real property taxes imposed on the buyer.

Proceeds from sales of securities. Brokers are required to report to the IRS on Form 1099-B gross proceeds from sales of stocks, bonds, commodities, regulated futures, and forward contracts. Commodity options are not covered by this reporting rule.

Miscellaneous income. Persons who, in the course of business, make payments totaling \$600 or more in the calendar year must file Form 1099-MISC with the IRS if the payments are in the form of:

1. Compensation for personal services (including salaries, wages, commissions, and professional fees) from which no tax is with-

held. However, no information return is required for payments to a domestic or other household employee;

2. Prizes and awards that are not for services, such as winnings on TV shows (gambling winnings are reported on Form W-2G); or
3. Payments of fees to physicians by insurance companies, such as Blue Cross, or by a government agency under Medicare or Medicaid. The physician or other health care provider must receive a copy of Form 1099-MISC by January 31, 1997, for inclusion of the amount on his or her 1996 return.

Retirement plan distributions. Distributions from pension, profit-sharing and annuity plans, IRAs, or simplified employee pension plans (SEPs) are reported on Form 1099-R. Contributions to an IRA and the year-end value of an IRA or SEP account are reported on Form 5498.

Mortgage interest. Banks, government agencies, and businesses receiving mortgage interest and points of \$600 or more for any calendar year report the payment to the IRS on Form 1098. The reporting requirement applies to interest on all obligations secured by real property. The lender must provide you with a statement of the interest reported to the IRS for 1996 by January 31, 1997.

Foreclosures and abandonments of property. If a business or government agency lends you money and later forecloses on your property or knows that you have abandoned property secured by the loan, the lender must file a report with the IRS on Form 1099-A. The purpose of the reporting requirement is to help the IRS check whether you have realized income from the discharge of indebtedness or gain on foreclosure, or whether you must recapture a previously claimed investment credit. If a report to the IRS has been made, you will be sent a statement by the lender by January 31 following the year of the foreclosure or abandonment.

Tax shelters. A new tax-shelter offering may be required to register with the IRS. If registration is required, the IRS assigns the tax shelter an identification number that must be furnished to investors. As an investor, you must report the registration number on Form 8271. Form 8271 must be attached to your tax return if you report any income or claim any deductions or credits from the shelter. Promoters of registered tax shelters and any other tax-shelter arrangements which the IRS considers potentially abusive must also keep a list of investors for seven years and provide the list to the IRS upon request. Furthermore, an investor who sells his interest in such a tax shelter to another investor must keep records identifying the buyer.

Cooperatives. Cooperatives must file annual information returns for patronage dividends totaling \$10 or more during the calendar year. A statement showing the amount reported must be furnished to the patron by the end of January of the following year; see Form 1099-PATR.

Partnerships. A partnership does not pay income taxes, but must file an annual information return (Form 1065), stating all items of income and deductions. Also included in the return are the names and addresses of all partners, and the amount of each partner's distributive share. The return is filed at the close of the partnership's tax year, whether or not it coincides with that of its partners. Failure to file the return will result in a penalty assessable against the partnership. If a

partner sells or exchanges a partnership interest and payment is partly attributable to the partner's share of unrealized receivables or substantially appreciated inventory, the partnership must be notified of the transaction and the partnership must then file an information return with the IRS, Form 8308. The purpose of the reporting requirement is to enable the IRS to verify the income attributable to the receivables and inventory, which is taxable as ordinary income. Statements to the transferor and transferee of the partnership interest must also be provided.

Barter transactions. The value of the trades by members of a barter club is subject to income tax. If you exchanged services or goods through a barter exchange during 1996, you should receive Form 1099-B from the exchange by January 31, 1997, showing the value received during 1996. The IRS also gets a copy.

Cancelled debts. If a financial institution or federal agency cancels or forgives a debt you owe of \$600 or more, the cancellation will be reported to the IRS on Form 1099-C and a copy sent to you. A cancellation of a debt is generally taxable, but see exceptions in ¶12.9.

¶47.3 When the IRS Can Assess Additional Taxes

Three-year statute of limitations. The IRS has three years after the date on which your return is filed to assess additional taxes. When you file a return before the due date, however, the three-year period starts from the due date, generally April 15.

Where the due date of a return falls on a Saturday, Sunday, or legal holiday, the due date is postponed to the next business day.

EXAMPLES

1. You filed your 1993 return on February 4, 1994. The last day on which the IRS can make an assessment on your 1993 return is April 15, 1997.
2. You file your 1996 return on May 27, 1997. The IRS has until May 27, 2000, to assess a deficiency.

Amended returns. If you file an amended return shortly before the three-year limitations period is about to expire and the return shows that you owe additional tax, the IRS has 60 days from the date it receives the return to assess the additional tax, even though the regular limitations period would expire before the 60-day period.

Six-year statute. When you fail to report an item of gross income which is more than 25% of the gross income reported on your return, the IRS has six years after the return is filed to assess additional taxes.

Where a false or fraudulent return is filed with intent to evade the tax, or where no return is filed, there is no limitation on when the tax may be assessed.

IRS request for audit extension. If the IRS cannot complete an audit within three years, it may request that you sign Form 872 to extend the time for assessing the tax. However, where an individual was “scared” into signing such an agreement, it was held invalid. See the following Example.

EXAMPLE

Robertson, a plumber, won \$30,000 in a sweepstakes. An IRS agent asked him to sign an extension agreement. Robertson never had any prior dealings with the IRS, he did not know that his return was under examination, and he was not in touch with the lawyer who prepared the return on which his sweepstakes winnings were averaged.

Robertson wanted to see his lawyer before signing Form 872, but the agent pressed hard for the signature, phoning him and his wife at home and at work 20 times in a week. The agent did not tell him the amount of additional tax that might be involved, or explain that if he refused to sign he would have an opportunity before the IRS and the courts to contest any additional tax. Instead, the agent’s comments gave him the impression that his home could be confiscated if he refused to sign. Robertson signed and the IRS later increased his tax.

Robertson argued that the agreement was not valid. He signed under duress. The Tax Court agreed. He convinced the court that he really believed he could lose his house and property if he did not comply. No adequate explanation of the real consequences of refusal to sign was made, although Robertson asked. Since he signed Form 872 under duress, the IRS could not increase his tax after the three-year period.

IRS interest rates on taxes owed are as follows:

From—	To—	Deficiency Rate—
7/1/96	12/31/96	9%
4/1/96	6/30/96	8
7/1/95	3/31/96	9
4/1/95	6/30/95	10
10/1/94	3/31/95	9
7/1/94	9/30/94	8
10/1/92	6/30/94	7
4/1/92	9/30/92	8
1/1/92	3/31/92	9
4/1/91	12/31/91	10
10/1/89	3/31/91	11
4/1/89	9/30/89	12
10/1/88	3/31/89	11
4/1/88	9/30/88	10
1/1/88	3/31/88	11
10/1/87	12/31/87	10
7/1/86	9/30/87	9

Refunds. The interest rate on refunds is 1% less than the rate on deficiencies. Generally, no interest is paid on a refund made within 45 days of the due date of the return (disregarding extensions). If you file after the due date, no interest is paid on a refund made within 45 days of the actual filing date.

¶47.5 Tax Penalties

Late payments. If you are late in paying your taxes, a nondeductible monthly penalty of 0.5% (½ of 1%) is imposed on the net amount of tax due and not paid by the due date. The maximum penalty is 25% of the tax due. The penalty is in addition to the regular interest charge. The penalty does not apply if you can show that the failure to pay is due to reasonable cause and not to willful neglect. The penalty does not apply to the estimated tax.

A similar penalty applies for failure to pay a tax deficiency within 10 calendar days of the date of notice and demand for payment if the notice and demand for payment from the IRS is before 1997. If the notice and demand is after 1996, and the tax due is less than \$100,000, the penalty-free payment period is 21 calendar days. If the tax is \$100,000 or more, the penalty-free payment period is 10 business days.

The monthly penalty may be doubled to 1%, if, after repeated requests to pay and a notice of levy, you do not pay. The increased penalty applies starting in the month that begins after the earlier of the following IRS notices: (1) a notice that the IRS will levy upon

¶47.4 Interest on Deficiencies

Interest is charged on a deficiency at rates listed in the following table. For periods after 1986, the rate changes quarterly. Interest begins to accrue from the due date of the return. As of January 1, 1983, interest is compounded daily except for estimated tax penalties. IRS tables on compound interest may be found in IRS Revenue Procedure 95-17. Where a taxpayer has relied on IRS assistance in preparing a return, and taxes are owed because of a mathematical or clerical error, interest does not begin to accrue until 30 days from a formal demand by the IRS for the payment of additional taxes.

your assets within 10 days unless payment is made and (2) a notice demanding immediate payment where the IRS believes collection of the tax is in jeopardy. If the tax is not paid after such a demand for immediate payment, the IRS may levy upon your assets without waiting 10 days.

Late filing. If your return is filed late without reasonable cause, the IRS may impose a penalty of 5% of the net tax due for each month the return is late, with a maximum penalty of 25%. If the return is more than 60 days late, the penalty will not be less than the smaller of \$100 and 100% of the tax due. In one case, the IRS tried to impose the \$100 minimum penalty on a taxpayer who did not owe any tax because her withholdings exceeded her liability. However, the Tax Court held that the minimum \$100 penalty does not apply unless tax is underpaid. The IRS has agreed to follow the decision.

If failure to file is fraudulent, the monthly penalty is 15% of the net tax due, with a maximum penalty of 75%.

If you are subject to penalties for both late payment and late filing, the 0.5% penalty for late payment (but not the 1% penalty) offsets the penalty for late filing.

Penalties for inaccurate returns. A 20% penalty generally applies to the portion of any tax underpayment attributable to (1) negligence or disregard of IRS rules and regulations; (2) substantial understatement of tax liability; (3) overvaluation of property; or (4) undervaluation of property on a gift tax or estate tax return. These penalties may be avoided by showing good faith and reasonable cause for the underpayment; a stricter version of this exception applies to charitable contribution overvaluations as discussed later in this section.

Negligence or disregard of IRS rules or regulations. The 20% penalty applies to the portion of the underpayment attributable to negligence. Negligence is defined as failing to make a reasonable attempt to comply with the law. Failure to report income shown on an information return, such as interest or dividends, is considered strong evidence of negligence, but negligence is not presumed as it was under prior law. For returns with an original due date before 1990, a 5% negligence penalty is applied to the entire underpayment where any part of it was attributable to negligence.



Too Good To Be True

If you claim a deduction, credit, or exclusion on your return that would seem to a reasonable person to be "too good to be true" under the circumstances, the IRS is likely to consider you negligent unless you show you made an attempt to verify the correctness of the position.

The 20% penalty may also apply if you take a position on a return which is contrary to IRS revenue rulings, notices, or regula-

tions. This penalty for disregarding IRS rules or regulations may be avoided if you have a reasonable basis for your position and you disclose that position on Form 8275 or on Form 8275-R in the case of a position contrary to a regulation. Thus, disclosure will not avoid a penalty for a position that does not have a reasonable basis.

Substantial underpayment of tax. If you understate tax liability on a return by the greater of \$5,000 and 10% of the proper tax, you may be subject to a penalty equal to 20% of the underpayment attributable to the understatement on returns due after 1989. A 25% penalty applied to returns due after October 21, 1986, and before 1990.

The penalty may be avoided if you have a reasonable basis for your position and you disclose the position to the IRS on Form 8275, or on Form 8275-R in the case of a position that is contrary to an IRS regulation.

The penalty also may be avoided if you can show that your position was supported by "substantial authority" such as statutes, court decisions, final, temporary, or proposed IRS regulations, IRS revenue rulings and procedures, and press releases or notices published by the IRS in the weekly Internal Revenue Bulletin. You may also rely on IRS private letter rulings and technical advice memoranda issued after October 31, 1976, and IRS actions on decisions and general counsel memoranda issued after March 12, 1981. However, according to the IRS, such rulings and internal IRS memoranda that are more than 10 years old should be accorded very little weight. Congressional committee reports and the tax law explanations prepared by Congress's Joint Committee on Taxation, known as the "Blue Book," may be relied on as authority for your position.

However, if an understatement of tax is due to tax-shelter items, having substantial authority for your position is not enough to avoid the penalty; you must also reasonably believe that your position was "more likely than not" correct. Disclosure does not avoid a penalty for tax-shelter items.

Overvaluing property or basis. The 20% penalty for overvaluing property, such as where inflated charitable contribution deductions are claimed or where the basis of depreciable property is inflated, applies *only* if the claimed value or basis is 200% or more of the correct amount. Furthermore, there is no penalty unless the tax underpayment attributable to the overvaluation exceeds \$5,000. The penalty rate is doubled to 40% if the overvaluation is 400% or more of the correct value. To avoid the penalty for donated property on the grounds that you had reasonable cause, the value must be based on a qualified appraisal (¶14.12) and your own good faith investigation of value.

Undervaluation on gift or estate tax return. If property is undervalued on a gift tax return or estate tax return by 50% or more, and if the tax underpayment attributed to the undervaluation exceeds \$5,000, a 20% penalty applies. The penalty doubles to 40% if the undervaluation is 75% or more.

Fraud penalty. A 75% penalty applies to the portion of any tax underpayment due to fraud. If the IRS establishes that any part of an underpayment is due to fraud, the entire underpayment will be attributed to fraud, unless you prove otherwise.

Interest on penalties. A higher interest cost is imposed on individuals subject to the following penalties: failure to file a timely return, negligence or fraud, overvaluation of property, undervaluation of gift or estate tax property, *or* substantial understatement of tax liability. Interest starts to run from the due date of the return (including extensions) until the date the penalty is paid. For other penalties, interest is not imposed, unless the penalty is not paid within 10 days of an IRS demand for payment made before 1997. If the demand is after 1996, and the penalty is less than \$100,000, the interest-free period is 21 calendar days, or 10 business days if the penalty is \$100,000 or more.

Acting on wrong IRS advice. A penalty will not be imposed if you rely on erroneous advice provided in writing by IRS officials. It is necessary for you to show that you provided accurate information when asking for advice.

¶47.6 Notify the IRS of Address Changes

If the IRS does not have your current address, payment of a refund due you may be delayed. If you owe taxes, the IRS may enforce a deficiency notice sent to the address on your most recently filed tax return, even if you never receive the IRS notice.

To avoid these problems, file Form 8822 with the IRS to provide notice of an address change. Alternatively, you may send a signed written statement to the IRS Service Center covering your old residence. The statement should state the new and old address, your full name, and your Social Security or employer identification number.

If you and your spouse separate after filing a joint return, you should each notify the IRS of your current address.

If after you move you receive an IRS correspondence that has been forwarded by the Post Office, you may correct the address shown on the letter and mail it back to the IRS. Your correction is considered notice of an address change.